

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Runner Analyst: Marion Mann DeJong Bill Number: AB 240  
Related Bills: See Legislative History Telephone: 845-6979 Introduced Date: 02/14/2001  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** MIC/Increase to 7% & Extend to Mineral Extraction & Electric Power Generation/Delete Repeal

### SUMMARY

This bill would:

- increase the Manufacturers' Investment Credit (MIC) from 6% to 7% of the cost of property used in manufacturing and certain other specified activities,
- extend the credit to certain electric power generation businesses,
- extend the credit to certain mineral extraction businesses, and
- extend the credit indefinitely.

### PURPOSE OF THE BILL

The purpose of this bill appears to be:

- to increase the incentive for manufacturing businesses to remain or locate in California,
- to encourage investment in property that generates electricity by alternative energy sources, and
- to encourage investment in property that extracts certain minerals.

### EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2001.

### POSITION

Pending.

### Summary of Suggested Amendments

Amendments are needed to clarify how extractive activities fit into the activities contained in the definition of qualified property. See "Implementation Considerations" below. Department staff is available to assist the author with amendments. Amendments are provided to delete references made obsolete by this bill. See "Technical Considerations" below.

Board Position:

\_\_\_\_ S      \_\_\_\_ NA      \_\_\_\_ NP  
\_\_\_\_ SA      \_\_\_\_ O      \_\_\_\_ NAR  
\_\_\_\_ N      \_\_\_\_ OUA      \_\_\_\_ X PENDING

Department Director

Date

Alan Hunter for GHG

03/22/01

## ANALYSIS

### FEDERAL/STATE LAW

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's trade or business. Also, these laws allow a depreciation deduction for the obsolescence or wear and tear of property used in a trade or business or held for the production of income.

Existing federal law does not have a credit comparable to the MIC. However, federal law does provide an investment property credit for certain depreciable or amortizable property that qualifies for the rehabilitation, energy, or reforestation credit. The energy credit is 10% of the basis of each item of energy property placed in service during the tax year. "Energy property" is:

- Equipment that uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat; or
- Equipment used to produce, distribute, or otherwise utilize energy from a geothermal deposit. In the case of electricity generated by geothermal power, only equipment used up to but not including the electrical transmission stage is "energy property."

Existing federal law also provides a renewable electricity production credit. For 2000, the credit is 1.5 cents per kilowatt hour of electricity produced at a "qualifying facility" by taxpayers from wind, "closed-loop biomass," (generally, organic plants, except timber, grown for the sole purpose of being used to generate electricity), or poultry waste. The electricity must be sold to an unrelated person during the taxable year. The credit is available for a ten-year period beginning the year the facility is placed in service.

Existing state law allows qualified taxpayers a credit, known as the MIC, equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California.

For purposes of the MIC, a qualified taxpayer is any taxpayer engaged in manufacturing activities described in specified codes listed in the Standard Industrial Classification (SIC) Manual, 1987 edition. Qualified property is any of the following:

1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code (IRC) and used primarily:

- for manufacturing, processing, refining, fabricating, or recycling of property;
- for research and development;
- for the maintenance, repair, measurement, or testing of otherwise qualified property; or
- for pollution control that meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.

3) For certain taxpayers engaged in specified SIC Code activities, special purpose buildings and foundations.

For taxpayers engaged in computer programming and computer software related activities, qualified property includes computers and computer peripheral equipment used primarily for the development and manufacture of prepackaged software, and the value of any capitalized labor costs directly allocable to such property.

The MIC explicitly excludes certain types of property from the definition of qualified property, such as furniture, inventory, and equipment used in an extraction process.

The MIC would sunset on January 1, 2001, or January 1<sup>st</sup> of the earliest subsequent year if the Employment Development Department determines that manufacturing (excluding aerospace) employment in California on the preceding January 1<sup>st</sup> does not exceed the January 1, 1994, employment level by at least 100,000 jobs. This employment test (100,000 additional manufacturing jobs) has already been met, thus the MIC will not expire unless California suffers from a severe recession and loses a significant number of manufacturing jobs.

### THIS BILL

This bill would increase the MIC from 6% to 7% of the qualified costs of qualified property placed in service in taxable years beginning on or after January 1, 2001. The 1% increase would not apply to MIC carryovers.

This bill would add taxpayers engaged in extracting nonmetallic mineral activities and electric service activities to the definition of "qualified taxpayer." The extracting nonmetallic mineral activities are described in Standard Industrial Classification (SIC) Codes 1411 to 1499, inclusive, as follows:

- 141 DIMENSION STONE
  - 1411 Dimension Stone
- 142 CRUSHED AND BROKEN STONE, INCLUDING RIPRAP
  - 1422 Crushed and Broken Limestone
  - 1423 Crushed and Broken Granite
  - 1429 Crushed and Broken Stone, Not Elsewhere Classified
- 144 SAND AND GRAVEL
  - 1442 Construction Sand and Gravel
  - 1446 Industrial Sand
- 145 CLAY, CERAMIC AND REFRACTORY MINERALS
  - 1455 Kaolin and Ball Clay
  - 1459 Clay, Ceramic and Refractory Minerals, Not Elsewhere Classified
- 147 CHEMICAL AND FERTILIZER MINERAL MINING
  - 1474 Potash, Soda, and Borate Minerals
  - 1475 Phosphate Rock
  - 1479 Chemical and Fertilizer Mineral Mining, Not Elsewhere Classified
- 148 NONMETALLIC MINERALS SERVICES, EXCEPT FUELS
  - 1481 Nonmetallic Minerals Services, Except Fuels
- 149 MISCELLANEOUS NONMETALLIC MINERALS, EXCEPT FUELS
  - 1499 Miscellaneous Nonmetallic Minerals, Except Fuels

The electric service activities are described in SIC Code 4911 as establishments engaged in the generation, transmission, and/or distribution of electric energy for sale. Taxpayers holding a Certificate of Public Convenience and Necessity issued by the California Public Utilities Commission would not be qualified taxpayers for purposes of the MIC.

This bill would modify the definition of “qualified property” to include tangible personal property (IRC Section 1245(a) property) used by a qualified taxpayer in extracting nonmetallic mineral activities and electric service activities primarily for “extracting property” or “generation of electricity.” This bill would further modify the existing definition of qualified activity within the qualified property rules by expanding the commencement point of the manufacturing or other process to include the period when raw materials are “obtained” within this process.

This bill would modify the list of excluded property to include certain property used in the extraction process in the definition of qualified property. Specifically, equipment used for extraction processes described in SIC Codes 1411 to 1499, inclusive, would be considered qualified property.

This bill would delete the repeal date, making the credit permanent.

This bill also would make minor technical changes to delete obsolete language referencing the low-emission vehicle credit, specify specific statutes that amended the MIC, and change “which” to “that” in various places.

#### IMPLEMENTATION CONSIDERATIONS

Under current law, the definition of qualified property includes tangible personal property used for specified activities, beginning with the point raw materials are introduced to the process and *ending at the point the activity has altered tangible personal property to its completed form, including packaging, if required.* This bill would add “extracting” to the list of activities that define the end of the “process.” However, it is unclear whether extractive activities result in the altering of tangible personal property to its completed form. Thus, the definition of qualified property may not properly address extractive activities. This could result in some extractive industry taxpayers not being entitled to the MIC as intended by this bill. This could result in disputes between taxpayers and the department.

#### TECHNICAL CONSIDERATIONS

This bill would remove the repeal date from the credit. However, two references to the sunset date remain in the credit. Amendments are provided to remove the references.

#### **LEGISLATIVE HISTORY**

*AB 1062, Battin (1997/1998)* would have increased the MIC from 6% to 8% of qualified costs. *AB 1062* was held in the Assembly Revenue and Taxation Committee.

*AB 473, Hertzberg (1999/2000)* would have extended the repeal date to January 1, 2004. *AB 473* was held in the Senate Appropriations Committee. *AB 2461, Runner (1999/2000)* was identical to this bill. *AB 2461* was held in the Assembly Revenue and Taxation Committee. *AB 2596, Corbett (1999/2000)* would have extended the MIC to taxpayers engaged in the generation of electricity using natural gas. *AB 2596* was held in the Assembly Appropriations Committee. *SB 1920, Kelley (1999/2000)* would have extended the MIC to certain electric power generation corporations. *SB 1920* was held in the Senate Revenue and Taxation Committee.

*AB 110, Zettel (2001)* would increase the MIC from 6% to 9% of qualified costs. *AB 110* is in the Assembly Revenue and Taxation Committee. *AB 278, Cohn (2001)* would increase the MIC to 7% and extend the repeal date to January 1, 2008. *AB 290, Cogdill (2001)* would extend the MIC to taxpayers engaged in certain agricultural or nonmetallic mineral extraction activities. *AB 45X, Kelley (2001)* would extend the MIC to taxpayers engaged in certain electric power generation activities. *AB 45X* is in the Assembly Revenue and Taxation Committee.

## OTHER STATES' INFORMATION

*New York* provides an investment tax credit (ITC) to manufacturers for depreciable equipment or buildings. The credit is 5% of up to \$350 million of qualified expenditures and 4% for qualified expenditures in excess of \$350 million. Research and development (R&D) property may qualify for an optional rate of 9%.

*Illinois* provides a replacement tax investment credit equal to 0.5% of the basis of qualified property used in Illinois by a taxpayer primarily engaged in manufacturing, retailing, coal mining, or fluorite mining.

*Massachusetts* provides a 3% credit based on the cost of qualified property used for manufacturing, farming, fishing, or research and development.

*Michigan* provides a graduated investment tax credit based on adjusted gross receipts of a firm. The credit is a percentage (0.85% to 2.3%) of the net costs of qualifying tangible, depreciable assets located in Michigan.

## FISCAL IMPACT

If the implementation considerations addressed in this analysis are resolved, the department's costs are expected to be minor.

## ECONOMIC IMPACT

Revenue Estimate:

Extending the MIC to nonmetallic minerals and certain electric power production and increasing the credit from 6% to 7% would result in the following revenue losses:

Revenue Impact of AB240 For Taxable Years Beginning On Or After January 1, 2001 Assumed Enactment After June 30, 2001 (In Millions)		
2001-02	2002-03	2003-04
-\$80	-\$95	-\$100

Eliminating the repeal date from the MIC would not impact current revenues. It is anticipated that the MIC would not sunset under the current law requirement.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

#### Revenue Discussion:

This estimate is based on data from an U.S. Census Bureau survey of capital expenditures by relevant industries for 1997 and microsimulation models of California tax returns for tax years 1997 and 1998. These numbers were grown to approximate 2001 and beyond. The credit use rates taken from the models were then applied to derive the aggregate credit use. The fiscal year cash flow patterns are based on the department's analysis of how manufacturers adjusted their tax payments to reflect the reduction in liability resulting from the current law MIC.

This estimate does not include losses resulting from qualified taxpayers as defined under current law that might receive an additional credit under this bill for activities that would qualify under the changes made by this bill that would not otherwise be entitled to the credit for these activities absent the amendments made by this bill. For example, the expansion of the definition of when the "process" begins might result in additional property qualifying for the credit, and the addition of certain power generation activities by taxpayers not classified under SIC Code 4911 that do not qualify under current law may result in these taxpayers being entitled to the credit for their power generation activities relating to their existing manufacturing and similar activities. Such losses cannot be quantified since the data and information needed are not available.

#### **SUPPORT/OPPOSITION**

Support: California Manufacturers and Technology Association

Opposition: Unknown

#### **ARGUMENTS/POLICY CONCERNS**

This bill would benefit transactions for which binding contracts already exist and would not be limited to benefit only future business decisions. Contracts entered into after January 1, 1994, but prior to enactment of this bill, already qualify for the credit, and existing binding contracts that require the payment of otherwise qualified costs under the MIC would qualify for the increased MIC benefit (additional 1%) provided under this bill.

The bill would amend the qualified activity definition within the qualified property definition by expanding the "process" (manufacturing, processing, refining, etc.) to include "the point at which any raw materials are obtained." Because this change is not limited to the extractive activities added by this bill, it would allow existing qualified taxpayers to claim the MIC for equipment used to transport raw materials from the point that they are obtained (for example, a warehouse owned by the taxpayer) to the actual manufacturing, fabricating, etc., site. Under current law, such equipment would not qualify for the MIC because the MIC is limited to equipment use beginning at the point where raw materials are "received."

Further, if the term "obtained" were construed to mean the point at which title transfers, then a taxpayer that transported raw materials by trucks that it owned or leased, regardless of distance, might be entitled to claim the MIC for the costs of the trucks. Under current law the trucks would not qualify since they would not be treated as equipment used in the "process" qualifying the taxpayer for the MIC. Instead they would be used either to transport the raw materials to the manufacturing site or to transport the finished product to the retailer or ultimate consumer, neither of which would qualify for the MIC.

#### **LEGISLATIVE STAFF CONTACT**

Marion Mann DeJong  
Franchise Tax Board  
845-6979

Brian Putler  
Franchise Tax Board  
845-6333

Analyst	Marion Mann DeJong
Telephone #	845-6979
Attorney	Patrick Kusiak

FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO AB 240  
As Introduced February 14, 2001

AMENDMENT 1

On page 11, modify lines 14 and 15 as follows:

on or after January 1, 1994, ~~and prior to the date this section ceases to be operative under paragraph (2) of subdivision (i),~~ shall be

AMENDMENT 2

On page 23, modify lines 8 and 9 as follows:

on or after January 1, 1994, ~~and prior to the date this section ceases to be operative under paragraph (2) of subdivision (i),~~ shall be